DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0132
Indiana Corporate Income Tax
For the Tax Periods Ending in 1996, 1997, and 1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. **Unitary Filing Requirement** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); IC 6-3-2-2(m); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Bethlehem Steel Corp. v. Ind. Dept of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Marshalk v. Green, 746 F.2d 927 (2d Cir. 1984); PepsiCo, Inc. v. Grapette Co, 416 F2d 825 (9th Cir. 1969); Commissioner's Directive 10, February 1, 1984; J. Gilson, Trademark Protection and Practice (2001); Tax Management Multistate Tax Portfolios (1998).

Taxpayer argues that the Department of Revenue – in calculating taxpayer's Indiana income – erred when it recomputed taxpayer's adjusted gross income to reflect all members of taxpayer's federal affiliated group of companies on a unitary basis.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of operating department stores and other businesses which sell clothing. During the tax years at issue, taxpayer operated as the parent company for two subsidiaries. In turn, both subsidiaries operated separate department store chains. Both subsidiaries have stores in Indiana, and both subsidiaries do business within Indiana.

In Year 1, Subsidiary One transferred certain trademarks to a branch operating division in State X (Holding Company One). Holding Company One pre-existed the transfer of the trademarks but had previously been in the business of owning and managing a warehouse center which served Subsidiary One's stores in State X and surrounding states.

Subsidiary One transferred the trademarks in an exchange described by taxpayer as, "a contribution to the capital of [Holding Company One] by [Subsidiary One] pursuant to section 351 of the Internal Revenue Code." Following the initial transfer, Holding Company One licensed the use of the trademarks back to Subsidiary One under "arm's length licensing agreements." Subsidiary One paid royalties to Holding Company One for the privilege of using the same trademarks it had owned before entering the Year 1 transfer agreement.

Subsidiary Two – also in the business of operating a chain of department stores – was acquired by taxpayer from a third-party in Year 2. After acquiring Subsidiary Two, taxpayer arranged for Subsidiary Two to transfer its own trademarks to a second company also located in State X (Holding Company Two). The exchange was made "as a contribution to capital of [Holding Company Two]." Subsidiary Two entered into a licensing agreement whereby it paid royalties to Holding Company Two for the right to employ the trademarks Subsidiary Two owned before the transfer.

Neither Holding Company One nor Holding Company Two have property or employees outside of State X. As taxpayer explains, both Holding Company One and Holding Company Two, "employ[] various individuals and contracts with various service providers in State X to conduct its business of owning, maintaining and licensing trademarks." According to taxpayer, both Holding Company One and Holding Company Two are in the business of managing trademarks.

During 2000, the Department conducted an audit of taxpayer's business records and tax returns. The audit reviewed the tax years ending in January 1996, January 1997, and January 1998. In doing so, the audit determined taxpayer's adjusted gross income should be recomputed on a unitary basis to reflect all members of the taxpayer's federal affiliated group including both Holding Company One and Holding Company Two. It did so on the ground that the royalty payments to the two holding companies "distorted income derived from Indiana sources due to the artificially created royalty expenses." In addition, the audit "determined that computing the Indiana adjusted gross income on the unitary basis more fairly reflects the income derived from Indiana sources." As a result of the audit's decision, the Department concluded that taxpayer owed additional Indiana corporate income tax.

Taxpayer took issue with this conclusion and submitted a protest to that effect. An administrative hearing was held during which taxpayer explained the basis for its protest, and this Letter of Findings follows.

DISCUSSION

I. Unitary Filing Requirement – Adjusted Gross Income Tax.

The audit determined that taxpayer's out-of-state holding companies had a "unitary business" with taxpayer. As a result, the audit found that taxpayer had a "unitary relationship" with the two holding companies and that taxpayer was required to report its Indiana income on a unitary basis. The audit's decision had the effect of subjecting the royalty income paid the State X holding companies to Indiana corporate income tax. Taxpayer argues that the audit's decision, imposing a combined unitary filing method, is an arbitrary abuse of statutory discretion.

The audit imposed the unitary filing requirement under authority of IC 6-3-2-2(m) which provides as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among

> those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
>
> (1) separate accounting;
>
> (2) the exclusion of any one (1) or more of the factors;
>
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from the language contained with IC 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the unitary reporting method of which taxpayer complains – are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

Taxpayer argues that the standard apportionment filing method is the correct means by which to report its Indiana income. In support, taxpayer cites to Commissioner's Directive 10, February 1, 1984 (Deleted August 1994) which states that the resort to IC 6-3-2-2-2 is "available when the standard methods of apportioning income cease to fairly reflect the income derived from Indiana sources" and should only be employed "when the standard three-factor formula clearly does not fairly reflect income." In further support, taxpayer maintains that the royalty payments were not arbitrary disbursements of Indiana income but were predicated on the basis of an independent and arms-length assessment of the value of the trademarks. In addition, taxpayer states that the decisions to "compartmentalize" the trademarks was warranted by concerns that the trademarks should be protected from future, unrelated legal actions brought against the taxpayer or any of its subsidiaries.

The Department concludes that the audit was warranted in requiring that taxpayer report its Indiana income on a unitary basis because, other than the favorable tax consequences attendant upon the license-back arrangements, the taxpayer's justification for the trademark/royalty transactions is unsupported.

There is nothing to indicate that taxpayer's business operations were affected in any way by the transfer of the trademarks to the two holding companies. There is nothing to indicate that the two holding companies do anything to manage the trademarks or do anything to enhance the value of the trademarks. There is nothing to indicate that the two holding companies obtained any independent ownership of the trademarks or that taxpayer did not remain the true owner of the trademarks. There is little to indicate that two holding companies have any experience in or have any qualifications in the field of developing, managing, or exploiting intellectual property. Especially in view of Holding Company One's past experience – owning and managing warehouse property – the likelihood that Holding Company One would develop or protect the intellectual property seems dim indeed.

Taxpayer has provided information substantiating that it sought and obtained an independent evaluation of the "Marketing Intangibles and Royalty Rate Estimation." This report provides a detailed analysis of the taxpayer's business operation, the relationship between the trademarks and its business operations, and the value of the trademarks to the business operation. But the report is based on the assumption that the trademarks – consisting of slogans, catch-phrases, and words – have any value severed from the taxpayer's department store business. The notion that a holding company can own trademarks distinct from that which gives the trademarks value is unsupported in law, practice, or business-reality. Taxpayer's entire assumption is flawed because a trademark "is merely a symbol of goodwill; it has no independent significance apart from the goodwill it symbolizes." Marshalk v. Green, 746 F.2d 927, 929 (2d Cir. 1984). "There are no rights in a trademark apart from the business with which the mark has been associated; they are inseparable." Id. The trademarks themselves have no value because the trademarks are simply advertising tools symbolizing customer good will and the customer's willingness to purchase – and repurchase – the taxpayer's products. J. Gilson, Trademark Protection and Practice 1.03[6][a] (2001). The fact that the independent evaluation placed a "value" on the trademarks, is insufficient to establish that the transfer of the trademarks to the two State X holding companies was anything more than an exercise in legal formalism.

Taxpayer's argues that it transferred the trademarks to the holding companies in order to protect the marks from the consequences of unrelated legal actions brought against taxpayer or its subsidiaries. Specifically, taxpayer notes that a foreign competitor brought a trademark infringement action against taxpayer and that the litigation was avoided only by entering into a settlement agreement. However, taxpayer's argument is inherently flawed because it proceeds from the premise that the trademarks – words, slogans, and catch-phrases – can be conceptually severed from the goodwill realized from taxpayer's relationship with its customers and the value which the customers attach to taxpayer's goods. It remains to be seen whether taxpayer's pro forma trademark transfer agreements and the subsequent royalty agreements have any legal effect in an unrelated legal action brought against the taxpayer and its subsidiaries. In the meantime, the Department is not required to attach any significance to the transfer and license-back arrangements.

The Department was justified in requiring the taxpayer to report its Indiana income on a unitary basis because the trademark/royalty transactions were entirely illusory. The transfer of the trademarks to the holding companies was illusory because the trademarks have no value distinct from the subsidiaries' goodwill. The royalty payments were illusory because the two subsidiaries

were paying for something which had no existence independent from the subsidiaries' own commercial activity. PepsiCo, Inc. v. Grapette Co, 416 F2d 825, 288 (9th Cir. 1969). The transfer of the trademarks to the holding companies was illusory because the holding company was incapable of managing or exploiting the intellectual property irrespective of the subsidiaries' business activities. The royalty payments were illusory because the holding companies simply "loaned" the money back to the two subsidiaries or invested the money on behalf of the two subsidiaries.

Although each of the four entities – Subsidiary One, Subsidiary Two, Holding Company One, and Holding Company Two – maintains separate and distinct identities, the relationship between the four parties has all the hallmarks of a unitary relationship. The four entities are owned, operated, managed and controlled by the same parent company; each of the four entities is one operational facet of the parent company's department store business. *See* Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

As taxpayer correctly states, it is entitled "to keep its taxes as low as possible as permitted under well settled law." ("The state of [X] does not impose a corporate income tax." Tax Management Multistate Tax Portfolios 1100:0086 (1998)). Nonetheless, the Department is also entitled to consider the "substance rather than the form of the transaction" Bethlehem Steel Corp. v. Ind. Dept of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992) in determining the tax consequences of taxpayer's license-back arrangements. After considering the substance of the license-back agreements and the unitary relationship between the commonly-owned parties, the Department concludes that the audit was justified in determining that the royalty payments artificially distorted taxpayer's Indiana income and requiring, as a consequence, that taxpayer report its Indiana income on a unitary basis.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 032407